

THE DECISION TO CONTRACT WORK OUT: HOW IMPORTANT ARE LABOR COSTS?¹

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Abstract

The main purpose of this paper is to identify the determinants of a plant's decision to outsource its intermediate stages of production, as well as its decision on how much to outsource. I focus primarily on the importance of high labor costs as a determinant of outsourcing and examine whether its importance changes over time, as suggested by the model introduced in this paper.

The results using the LRD are supportive of the view that wage savings are an important determinant of the plant's decision to outsource and the level of outsourcing for those plants that choose to outsource. I find larger plants and plants that are part of a multi-unit establishment are less likely to contract work out, although they contract out in higher levels if they decide to outsource. Industry affiliation is also an important determinant.

I then analyze the time-series variation in the importance of labor costs as a determinant of outsourcing behavior. The model of outsourcing introduced in this paper suggests that as the share of in-house production and the share of unskilled labor decrease over time, the importance of production-labor costs as a determinant of outsourcing should also decrease. I formally test these predictions of the model for the 1979-1998 period. My results suggest that, although labor costs are still an important determinant of how much to outsource, the responsiveness of the demand for contract work to changes in labor cost is decreasing over time for outsourcing plants. The importance of labor costs as a determinant of the decision to outsource decreases significantly over time and ceases to be significant for the last period I consider.

¹ The research in this paper was conducted while the author was a Census Bureau research associate at the Michigan Census Research Data Center. Research results and conclusion expressed are those of the author and do not necessarily indicate concurrence by the Bureau of the Census. This paper has been screened to insure that no confidential data are revealed.